No. 87-1735

In the Supreme Court of the United States

OCTOBER TERM, 1987

MARTIN H. FISHMAN, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether petitioners' distributive shares of certain costs incurred by their partnership prior to its completion of a shopping center complex were deductible under Section 212 of the Internal Revenue Code of 1954 (26 U.S.C.), as expenses incurred for the production of income.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A1-A22) is reported at 837 F.2d 309. The opinion of the Tax Court (Pet. App. B1-B22) is reported at 51 T.C.M. (CCH) 738.

JURISDICTION

The judgment of the court of appeals was entered on January 12, 1988. The petition for a writ of certiorari was filed on April 11, 1988. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. During 1976 and 1977, petitioners each owned an interest in a partnership that was formed in 1975 to develop a shopping center on a site in Champaign, Illinois. Use of this site was obtained by the partnership in July 1976 through a trust arrangement, which provided for a trustee-bank to acquire, on behalf of the partnership, a leasehold

interest in the property for 50 years, at a monthly ground rental of $2,500. In August 1976, the partnership received a permanent mortgage loan standby commitment from a bank; it paid a $9,000 commitment fee to the bank and an additional $9,000 fee to a firm for its services in negotiating the commitment. In November 1976, the partnership received a $900,000 construction loan from another bank, paying a commitment fee of $9,000. Pet. App. A3. On December 31, 1976, the partnership entered into a construction agreement with a contractor, providing that work on the shopping center was to be substantially completed by August 1, 1977, and fully completed 30 days thereafter (Pet. App. B6-B7).

On February 25, 1976, the partnership entered into a contingent lease with a commercial tenant. This agreement provided (Jt. Exh. 22-V):

> The term of this Lease and Lessee's obligations to pay rent hereunder shall commence on the earlier of: (a) August 1, 1977, (b) 90 days after notification to Lessee that its Premises are available to Lessee for purposes of Lessee making its tenant improvements, and (c) the day Lessee opens his business in the Premises.

The partnership entered into six similar lease agreements in 1976, and five more between January and November 1977. When groundbreaking for the shopping center took place in March 1977, approximately one third of the rental space at the shopping center had been leased to commercial tenants. Pet. App. A3-A4. On March 23, 1977, the ground lease was amended to require the partnership to provide an irrevocable letter of credit, which it obtained from a bank for a fee of $4,930.55 (Pet. App. B7-B8). In September 1977, the partnership advised its prospective tenants that their rental space would be available on September 30, 1977, and that rent would not be due until

November 1, 1977. This schedule went into effect as planned. Pet. App. A3, B8.

2. On its federal partnership information returns for the years 1976 and 1977, the partnership claimed losses of $59,875 and $40,977.05, respectively. The calculation of these losses included the deduction of various pre-operating expenses, such as loan commitment and professional fees, ground rent, and office costs.[1] Petitioners each filed federal income tax returns for 1976, 1977, and, in some instances, 1978, reflecting their distributive shares of the losses claimed by the partnership. On audit of the partnership, the Commissioner disallowed $59,875 and $20,517.71 of the losses claimed for the years 1976 and 1977, respectively. In the notices of deficiency sent to petitioners, the Commissioner determined that various of the expenses claimed by the partnerships in 1976 and 1977 were not currently deductible

[1] The following table summarizes deducted expenses that were incurred prior to November 1977 (see Pet. App. B9):

	Year Paid	
Item	*1976*	*1977*
Trust fee	$ 166.00	$ 95.00
Business promotion and organization	1,798.00	-0-
Advertising	391.00	-0-
Professional fees	7,930.00	-0-
Miscellaneous	655.00	20.19
Office expenses	293.00	-0-
Insurance	148.00	-0-
Consulting	1,340.00	-0-
Mortgage standby fee	22,500.00	-0-
Survey	666.00	-0-
Accounting and legal	-0-	350.00
Travel and auto	-0-	1,415.33
Telephone and office	599.00	1,169.66
Bank fee on letter of credit	-0-	4,930.55
Ground rent	23,389.00	17,500.00
Commitment fee	-0-	4,500.00
Totals	$59,875.00	$29,980.73

"because it ha[d] not been established that these expenditures were for ordinary and necessary business expenses." Petitioners' distributive shares of the disallowed partnership losses claimed on their respective returns for 1976, 1977, and 1978, were accordingly disallowed by the Commissioner. Pet. App. A4, B9.

3. Petitioners sought redetermination of the resulting deficiencies in the Tax Court, which ruled for petitioners in large part (Pet. App. B1-B22).[2] Relying on its previous reviewed decision in *Hoopengarner* v. *Commissioner*, 80 T.C. 538 (1983) (9-8 vote), aff'd, 745 F.2d 66 (9th Cir. 1984) (Table), and on its subsequent decision in *Johnsen* v. *Commissioner*, 83 T.C. 103 (1984), rev'd, 794 F.2d 1157 (6th Cir. 1986), the Tax Court allowed the deduction of the bulk of the partnership's expenses under Section 212 of the Internal Revenue Code,[3] as having been incurred for the production of income. The court explained that, under *Hoopengarner*, it was irrelevant whether such expenses were incurred prior to the commencement of the partnership's trade or business, in contrast to Section 162 of the Code, which would not permit the deduction of such "pre-opening expenses" as "business expenses" (see Pet. App. B10-B13, B18 n.4).[4]

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[2] The Tax Court agreed with the Commissioner that the $9,000 brokerage fee paid to secure the standby commitment for the permanent mortgage was a capital expenditure that must be amortized over the life of the mortgage (Pet. App. B13-B14) and that the professional fees were nondeductible partnership organizational expenses under 26 U.S.C. 709(a) (Pet. App. B14-B17).

[3] Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as amended (the Code or I.R.C.).

[4] Accordingly, the Tax Court found it unnecessary to decide whether the expenses in question were incurred before the partnership began to operate its business as a going concern.

4. The court of appeals reversed (Pet. App. A1-A12). The court noted that start-up costs are not deductible under Section 162 because they "yield benefits over the entire life of the enterprise, and therefore must be capitalized" (Pet. App. A9). The court found that the same principles should apply in the context of Section 212, which was designed to extend the benefits of Section 162 to income-producing activities that do not involve a "trade or business," but "was not intended to spare individuals who incurred expenses for the production of nonbusiness income from any of the 'restrictions and limitations that apply in the case of a deduction under' section 162" (Pet. App. A8, quoting H.R. Rep. 2333, 77th Cong., 2d Sess. 75 (1942)). Accordingly, the court of appeals held that start-up costs are not currently deductible under Section 212. The court thus expressly rejected the Tax Court's *Hoopengarner* decision, thereby aligning itself with the Sixth and Eighth Circuits. See *Johnsen* v. *Commissioner*, 794 F.2d 1157 (6th Cir. 1986); *Aboussie* v. *United States*, 779 F.2d 424 (8th Cir. 1985). Under the court of appeals' holding, if the costs in question were incurred before the commencement of the partnership's trade or business, they were capital expenditures that must be treated as part of the cost of acquiring the business; on the other hand, if they were incurred after the commencement of the business, they were currently deductible (Pet. App. A20). The court of appeals therefore remanded the case to the Tax Court to determine when the partnership's trade or business began.

ARGUMENT

Petitioners contend (Pet. 14-22) that their distributive shares of the partnership's pre-opening expenses are deductible under Section 212 of the Code. This contention was correctly rejected by the court of appeals. In addition, this

case does not merit this Court's review for several other reasons. First, review would be premature because the case is at an interlocutory stage. Second, the issue presented in this case is of little continuing importance because it has been definitively resolved by a statutory amendment applicable to tax years after 1984. Third, even as to earlier tax years, there is not a clear conflict in the circuits of the type that would require resolution by this Court.

1. At the outset, we note that this case is in an interlocutory posture at this time. The court of appeals has remanded the case to the Tax Court to determine when the partnership's business commenced as a going concern. Petitioners maintain (Pet. 22 n.6) that the resolution of this issue on remand will result in allowance of the disputed deductions.[5] Thus, it is possible that petitioners will prevail on remand without review of the decision below; if petitioners do not so prevail, the issue decided by the court below can be raised before this Court at a future time. Accordingly, the prudential considerations ordinarily applied by this Court counsel against granting certiorari at this interlocutory stage. See, *e.g.*, *Brotherhood of Locomotive Firemen & Enginemen* v. *Bangor & Aroostook R.R.*, 389 U.S. 327 (1967).

2. The issue presented in the petition has been definitively resolved by Congress for tax years beginning after June 30, 1984. In the wake of the Tax Court's decision in *Hoopengarner*, Congress acted to overturn that decision. Section 94 of the Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 614-615, amended Section 195 of the Code

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[5] The government disagrees with petitioners on this point. Because the expenses in question were incurred prior to actual operation of the shopping center, it is the government's position that they predated the commencement of the partnership's trade or business. See, *e.g.*, *Bennett Paper Corp.* v. *Commissioner*, 699 F.2d 450, 452 (8th Cir. 1983).

to state that, except as otherwise provided in that Section, "no deduction shall be allowed for start-up expenditures" (I.R.C. § 195(a)). The term "start-up expenditures" is defined by Section 195(c)(1)(A) to include any amount paid or incurred in connection with "creating an active trade or business" or with "any activity engaged in for profit and for the production of income before the day on which the active trade or business begins, in anticipation of such activity becoming an active trade or business." These amendments, which are effective for tax years beginning after June 30, 1984 (see § 94(c), 98 Stat. 615), clearly establish that start-up expenditures are not deductible under either Section 162 or Section 212 and thus they essentially codify the interpretation of Section 212 adopted by the court below. Indeed, the legislative history of these amendments specifically notes Congress's intent to overturn the *Hoopengarner* decision (see 1 Staff of the Senate Comm. on Finance, 98th Cong., 2d Sess., *Deficit Reduction Act of 1984,* at 283 (Comm. Print 1984)), and petitioners have acknowledged that Congress in 1984 "specifically set out to overrule [*Hoopengarner*]" (Pet. C.A. Br. 19). Thus, the question presented in the petition has little continuing importance.

Moreover, even as to the law applicable to cases not covered by the 1984 amendments, there is no "direct conflict" (Pet. 5) with the Ninth Circuit's affirmance of *Hoopengarner* that would warrant resolution by this Court. The Ninth Circuit affirmed the Tax Court's *Hoopengarner* decision in an unpublished memorandum (see 745 F.2d 66 (1984) (Table)). Under Rule 36.3 of the Rules of the Ninth Circuit, such an unpublished memorandum "shall not be regarded as precedent and shall not be cited to or by [the Ninth Circuit] or any district court of the Ninth Circuit," except for purposes relating to application of the doctrines of law of the case, collateral estoppel, and res judicata. Thus, if this issue were to arise again in the Ninth Circuit, *Hoopengarner* would not be binding precedent, and the

Ninth Circuit would be free to follow the subsequent decisions of the court below and of the Sixth and Eighth Circuits that have rejected *Hoopengarner.* See *Johnsen* v. *Commissioner,* 794 F.2d 1157 (6th Cir. 1986); *Aboussie* v. *United States,* 779 F.2d 424 (8th Cir. 1985).[6] Accordingly, there is no conflict of circuit precedent, and the conflict of decisions asserted by petitioners therefore provides no basis for review by this Court.

3. The court of appeals correctly rejected petitioners' contention that start-up costs are deductible under Section 212 for tax years beginning before June 30, 1984. Section 212 provides for the deduction of "all the ordinary and necessary expenses" paid or incurred "for the production or collection of income," or "for the management, conservation, or maintenance of property held for the production of income." Its predecessor, Section 23(a)(2) of the 1939 Code, was enacted following this Court's decision in *Higgins* v. *Commissioner,* 312 U.S. 212 (1941), which had held that expenses incurred by taxpayers in managing their individual securities portfolios were not expenses incurred in "carrying on any trade or business" within the meaning of the predecessor of Section 162(a) of the Code, and hence were

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[6] In addition to the fact that three courts of appeals have rejected *Hoopengarner* since it was affirmed by the Ninth Circuit, the likelihood that the Ninth Circuit would reach the same result in a future case is further diminished by the fact that the reasoning of the brief, unpublished memorandum affirming *Hoopengarner* has been undermined by subsequent developments. The court of appeals there had relied in large part upon Ninth Circuit precedent stating that "[b]ecause of its special expertise, the Tax Court's construction of the Internal Revenue Code should not be overruled unless it is unmistakably erroneous" (*Hoopengarner* v. *Commissioner,* No. 83-7693 (Sept. 14, 1984), slip op. 3). The Ninth Circuit has since explicitly repudiated that limited standard of review of Tax Court decisions. *Vukasovich, Inc.* v. *Commissioner,* 790 F.2d 1409, 1411-1413 (1986).

not deductible. In response, Congress in 1942 enacted Section 23(a)(2), which permitted "the deduction of some, but not all, of the [income-producing] nontrade and nonbusiness expenses of an individual taxpayer." *Lykes* v. *United States,* 343 U.S. 118, 121-122 (1952). See generally *United States* v. *Gilmore,* 372 U.S. 39, 45 (1963). As the court of appeals noted (Pet. App. A7-A8), the legislative history of the provision shows that it was intended to extend to nonbusiness income-producing activities some of the deductions previously available for business expenses, but was not intended to create an advantage for the former activities; thus, deductions under the new section were intended to be subject to "all the restrictions and limitations that apply in the case of the deduction * * * of an expense paid or incurred in carrying on any trade or business" (H.R. Rep. 2333, 77th Cong., 2d Sess. 75 (1942); S. Rep. 1631, 77th Cong., 2d Sess. 88 (1942)). The purpose of the new provision was "merely to enlarge 'the category of incomes with reference to which expenses were deductible.' " *United States* v. *Gilmore,* 372 U.S. at 45 (quoting *McDonald* v. *Commissioner,* 323 U.S. 57, 62 (1944)).

It is a fundamental principle of tax law that the cost of acquiring a long-lived asset must be capitalized. See generally *Commissioner* v. *Idaho Power Co.,* 418 U.S. 1, 12-13 (1974); *Woodward* v. *Commissioner,* 397 U.S. 572, 575 (1970). Applying this principle, the courts of appeals have consistently held that Section 162(a) of the Code does not permit the current deduction of start-up, or pre-opening, expenses incurred by taxpayers in establishing a trade or business. See, *e.g.*, *Central Texas Savings & Loan Ass'n* v. *United States,* 731 F.2d 1181, 1183 (5th Cir. 1984); *Bennett Paper Corp.* v. *Commissioner,* 699 F.2d 450, 451-452 (8th Cir. 1983); *Madison Gas & Electric Co.* v. *Commissioner,* 633 F.2d 512, 517 (7th Cir. 1980); *Richmond Television Corp.* v. *United States,* 345 F.2d 901 (4th Cir.), vacated on other grounds, 382 U.S. 68 (1965); see also Pet. App.

B18 n.4. These courts have stressed, as did the court below (see Pet. App. A10-A13), that proper tax accounting requires a matching of income against expenses and have concluded therefore that start-up expenses incurred in making a business operational must be capitalized, rather than currently deducted, because such expenses represent the cost of acquiring the business as a whole and the business itself has a useful life that extends well beyond the year in which the expenses are incurred. See, *e.g.*, *Central Texas Savings & Loan Ass'n* v. *United States,* 731 F.2d at 1185; *Richmond Television Corp.* v. *United States,* 345 F.2d at 907; *Cleveland Electric Illuminating Co.* v. *United States,* 7 Cl. Ct. 220, 228 (1985).

It is well established that Section 212, just like Section 162, does not permit the current deduction of capital expenditures. This Court explicitly stated in *Woodward* v. *Commissioner,* 397 U.S. at 575 (footnote omitted), that, "[i]f an expense is capital, it cannot be deducted as 'ordinary and necessary,' either as a business expense under [Section] 162 of the Code or as an expense of 'management, conservation, or maintenance' under [Section] 212." See also Treas. Reg. § 1.212-1(n). Since, as discussed above, expenses incurred to establish an enterprise are capital in nature, such amounts should not be currently deductible under Section 212. Petitioners' contention that they are currently deductible and the Tax Court's *Hoopengarner* decision upon which petitioners rely are thus inconsistent both with the fundamental principle requiring capitalization of capital expenditures and with the well-understood intent of Congress in enacting the predecessor of Section 212, namely, "to provide for a class of nonbusiness deductions *coextensive* with the business deductions allowed by [the predecessor of Section 162(a)]." *Trust of Bingham* v. *Commissioner,* 325 U.S. 365, 374 (1945) (emphasis added).

Petitioners seek to avoid this conclusion by arguing (Pet. 17-18) that the items in question here, particularly the ground rental payments, typically are not considered capital expenditures. But, as the court of appeals explained (Pet. App. A16-A19), whether or not certain expenses are capital in nature depends upon the purposes for which the funds are expended. Where, as here, certain expenses are incurred in order to establish a business, those are capital expenditures, even though similar expenses might not be capital if incurred in the course of operating an ongoing trade or business. This point is well illustrated by this Court's decision in *Commissioner* v. *Idaho Power Co., supra.* There, the Court held that depreciation allowed with respect to trucks being used to construct a power plant could not be currently deducted, but should be capitalized as part of the basis of the plant, even though depreciation ordinarily gives rise to a current deduction. The Court found the capitalization of depreciation cost in this situation to be analogous to the capitalization of construction wages. The Court stated (418 U.S. at 13): "Of course, reasonable wages paid in the carrying on of a trade or business qualify as a deduction from gross income. * * * But when wages are paid in connection with the construction or acquisition of a capital asset, they must be capitalized * * *." The Court concluded that the depreciation "cost, although certainly presently incurred, is related to the future and is appropriately allocated as part of the cost of acquiring an income-producing capital asset" (*id.* at 11). This analysis is equally applicable to the expenses at issue here, and the court of appeals correctly held that they cannot be currently deducted if they were incurred before the partnership's business had begun.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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